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THE FOREIGN TRADE ZONE FACTOR IN U.S.-JAPAN ECONOMIC RELATIONS

Summary

Foreign trade zones, areas within the United States that are considered outside U.S. customs territory, were authorized by Congress in 1934 to boost foreign commerce. The program got off to a slow start but recently has been expanding. Regulatory decisions made in the 1980s increased the incentives for manufacturing in foreign trade zones. This development led to enormous growth in FTZ use and also introduced an element of controversy. Allegations arose that the program harms some domestic industries by making it easier for zone manufacturers -- domestic or foreign-owned -- to incorporate foreign components into their products.

Among the benefits foreign trade zones extend to users are the opportunity to avoid, postpone or reduce tariffs on foreign goods. The program is especially attractive to producers in industries where tariffs on parts are higher than on the finished product, the automotive industry in particular. Car and truck assembly plants account for a significant share of zone activity; not coincidentally, American automotive parts manufacturers are among the most vociferous critics of the FTZ program.

Several years ago Congress took a close look at the operation of foreign trade zones and solicited views on the program from independent agencies, the private sector and the executive branch. The program's governing board now is working on the latest revisions of its guiding regulations. The redrafting process has highlighted the conflict between those who believe the program boosts overall American competitiveness by making manufacturing in this country more attractive and those who argue that

foreign trade zones undermine the competitiveness of certain domestic industries. Although the debate has been somewhat subdued recently, increasing concern over the growing U.S. automotive parts deficit with Japan seems likely to refocus attention on foreign trade zones and their pivotal role in automotive manufacturing in the United States.

Origins of the Foreign Trade Zone Program

Congress passed the Foreign Trade Zone Act in 1934 to "expedite and encourage foreign commerce." Under the sponsor's list of aims were: "to encourage transshipment out of the country of goods that have been imported, to encourage the admixture of foreign goods with domestic goods and then shipping them outside the country."[1] Supporters of the act hoped the economy, which was in the throes of the Depression, could be reinvigorated by expanded trade, particularly transshipments (unloading foreign goods and reloading them to be sent to another country) and reexports. In their efforts to remove impediments to transshipments and reexports many lawmakers appeared wary of creating a program that would encourage greater imports. To address this concern the 1934 legislation explicitly excluded manufacturing and even exhibiting from FTZ activities.

The intent of the legislators who crafted the Foreign Trade Zone Act has been disputed ever since, particularly in the context of proposed changes to the current operation of the FTZ program. Most of the debate revolves around whether Congress intended FTZs to encourage imports. Critics who contend that the current program promotes imports argue that revisions made since 1934 caused the program to stray from the original legislative intent. The first major revision to the act was a 1950 amendment that allowed manufacturing and exhibiting in FTZs, a change meant to spur the establishment of zones and open up greater opportunities for American participation in international trade. Proponents framed the increase in imports expected to result from this amendment as a means of using American labor and materials to boost subsequent U.S. exports and of assisting European economies devastated by the war through purchases of their raw materials.

Accounts of the debate leading up to the 1950 amendment indicate that legislators and executive-branch representatives believed space and other constraints would limit manufacturing activity in foreign trade zones, which are located in or near U.S. Customs ports of entry. In 1952, however, regulations implementing the FTZ act were revised to allow for subzones -- special-purpose

[1]U.S. Congress, House Committee on Ways and Means, Hearings on H.R. 3657, Foreign Trade Zones, 73rd Congress, 2nd Session, March 6 and 7, 1934, cited in U.S. Congress, House Committee on Government Operations, Foreign-Trade Zones [FTZ] Program Needs Restructuring (Washington, D.C.: November 6, 1989), p. 27.

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zones that are physically removed from their sponsoring general-purpose zone. While there is no legal difference in the kind of operation allowed in the two types of zones, general-purpose zones tend to incorporate several businesses that utilize the area for distribution or warehousing, while subzones encompass single-user manufacturing or assembling facilities.

Both types of foreign trade zones are considered outside the customs territory of the United States. This status allows firms bringing foreign goods into a zone to avoid customs entry procedures as well as the payment of duties and compliance with such restrictions as import quotas unless and until the goods enter U.S. customs territory. Zone status provides firms intending to sell their products in the domestic market with several advantages, such as delaying tariff payments and extending the opportunity to choose whether to pay duty on foreign materials when they are brought into the zone or when they enter U.S. customs territory. Duties on components generally are lower than on finished products, but in "inverted tariff" situations rates on finished items are lower than on some of the components. Completing products in a foreign trade zone, therefore, allows firms in industries subject to inverted tariffs to bring imported materials and components into the United States while taking advantage of the lower duties applicable to finished goods.

Recent Changes in the FTZ Program

Since establishment of the program the FTZ legislation has been amended and the implementing regulations have been revised, both with an eye to encouraging the use of FTZs and to resolving either zone users' problems or those of their competitors. Although the 1950 amendment to allow manufacturing in zones and the ensuing administrative authorization for subzones constituted a significant change in the program, these changes did not bring about an immediate surge in activity. The boom in manufacturing in subzones, considered the main source of increased zone activity, appears to have been spurred by more recent regulatory changes. A 1980 Department of the Treasury ruling removed from the dutiable value of a finished product the value added in the zone -- defined as a percentage of the value of processing and/or manufacturing costs as well as overhead and profit. The stated objective of this revision was to entice foreign automotive manufacturers to locate their operations in the United States. For some manufacturers paying duty on value added would have outweighed the benefits of utilizing a zone. A 1982 Customs Service decision further augmented duty savings opportunities for zone users by deleting brokerage and insurance fees plus transportation costs from the dutiable value of finished products. Reducing the dutiable value of goods processed in a zone to the value attributable to the foreign components in the finished product greatly boosted the appeal of subzone manufacturing.

More recent amendments made to the Foreign Trade Zone Act also have been aimed at increasing zone use in general and in specific sectors. For example, the act has been amended to exempt from state and local ad valorem taxation certain personal property located in an FTZ and to allow the use of domestic denatured spirits to make products in FTZs. Some legislation, however, has led to restrictions. The benefits of producing bicycles in zones were curtailed under legislation passed in direct response to concerns voiced by the domestic bicycle parts industry. None of the amendments enacted recently represents significant legislative change.

Expansion of FTZ Operations

By early 1991 more than 170 general-purpose zones and nearly 200 subzones had been authorized by the Foreign Trade Zones Board, which includes the secretaries of the Departments of Commerce and Treasury as well as the Secretary of the Army. (The input of each representative involved in the approval process roughly follows his or her agency's area of jurisdiction. The secretary of commerce serves as chairman of the FTZ board; Commerce also supplies the board with a small staff. The Army Corps of Engineers has the job of assessing the potential impact of FTZs on port and river facilities as well as on the environment.) Although not all the authorized zones are now in use, current figures far surpass the number of FTZs permitted prior to regulatory changes in the 1980s. In 1980, for example, there were only 54 general-purpose zones and nine subzones.

The value of merchandise going into foreign trade zones totaled $76.3 billion in 1989 -- the most recent data available (see Table). This reflected a 30 percent increase over the previous year and a striking contrast to 1980 when the value of materials moved into zones was $2.6 billion.

More than 2,000 firms used FTZs in 1989 for manufacturing, repackaging and dozens of other activities. Approximately 80 percent of these users are U.S.-based companies, recent estimates indicate. A list distributed by the FTZ board showing the main products produced in FTZs in 1989 included refined petroleum products, nonelectric machinery, electronics, orange juice concentrate and toiletries. Automotive assembly plants, however, constitute an overwhelming share of zone activity -- roughly 80 percent.

Although the number of general-purpose zones has increased steadily over the years, subzones nearly doubled in number between 1982 and 1983. With rapid growth since then the number of subzones surpassed general-purpose zones in 1990. Subzones have accounted for more than half the goods received in zones since 1979, and in the second half of the 1980s the figure was 90 percent-plus. In 1989, for example, subzones received $71.2 billion worth of goods, 93.3 percent of the total for all zones.

Data collected by the Foreign Trade Zones Board show that from 1985 to 1989 the share of domestic components in goods produced in subzones hovered around 80 percent. The foreign component in general-purpose zones far outweighed the domestic input, a reflection of the fact that these zones are used mainly for such activities as distribution and storage.

The FTZ Board points to a positive trend in the average ratio of exports to imports from a pre-1980 ratio of 0.3 to 1 to the 1989 level of 0.5 to 1. Yet critics of the FTZ program tend to highlight another ratio -- the percentage of zone shipments that enters the domestic market. While 33 percent of total shipments from general-purpose zones was exported in 1989, only 11 percent of shipments from subzones went to foreign markets. Zone shipments increasingly have been directed toward the American market since the mid-1970s, a trend that concerns those who believe FTZs displace domestic production.

Shifts in FTZ Use

A key factor behind the recent shift to subzones is the growing involvement of motor vehicle firms in the FTZ program. The first license for an automotive assembly subzone was granted in 1977; by 1986 the 24 active automotive

Foreign Trade Zone Statistics, 1989

(in billions of dollars unless otherwise indicated)

	1985	1986	1987	1988	1989
Merchandise Received					
General-Purpose Zones	$2.0	$2.6	$3.1	$4.3	$5.1
Subzones	22.8	37.6	45.8	54.4	71.2
Total	24.8	40.2	48.9	58.7	76.3
Foreign Receipts					
General-Purpose Zones	1.6	2.3	2.6	3.8	4.4
Subzones	4.1	6.9	7.9	10.3	14.4
Total	5.7	9.1	10.5	14.1	18.8
Domestic Inputs (%)					
General-Purpose Zones	19%	13%	17%	11%	13%
Subzones	82%	82%	83%	81%	80%
Average	77%	77%	79%	76%	75%
Outbound Shipments					
General-Purpose Zones	1.8	2.6	3.0	4.0	4.7
Subzones	32.7	47.5	52.6	68.1	80.5
Total	34.4	50.1	55.6	72.1	85.2
Exports					
General-Purpose Zones	0.6	0.7	0.9	1.1	1.5
Subzones	3.3	4.2	4.5	6.2	9.2
Total	3.9	4.9	5.4	7.2	10.7
Export Ratio (%)					
General-Purpose Zones	33%	26%	29%	26%	33%
Subzones	10%	9%	9%	9%	11%
Average	11%	10%	10%	10%	13%

Source: 51st Annual Report of the Foreign-Trade Zones Board to the Congress of the United States.

assembly subzones accounted for roughly 85 percent of the merchandise moving into all zones. Analysts point to several factors as being behind the steady growth of automotive assembly subzones since 1977. Increasingly stiff competition for sales in the American market between U.S. car and truck manufacturers and their foreign rivals forced the Big Three to make a number of adjustments; one of these included greater use of imported parts. Domestic automotive industry representatives note that the opportunity to use subzones to postpone and substantially decrease duties makes the incorporation of imported components into their finished products economically viable and helps them keep up with foreign automakers.[2]

[2]U.S. General Accounting Office, Foreign Trade Zone Growth Primarily Benefits Users Who Import for Domestic Commerce, Report to the Chairman, Committee on Ways and Means, House of Representatives (Washington, D.C.: March 1984), p. 12.

Another way in which U.S. automotive manufacturers have sought to boost their competitiveness is through joint ventures with Japanese motor vehicle firms; this, too, has been a factor behind increased FTZ use. Moreover, while regulatory revisions in the FTZ program served as the carrot for Japan's automotive exporters to assemble their products in the United States, political-economic pressure provided a stick in various forms, such as the voluntary export restraint arrangement on cars reached with Japan in 1981 and domestic content bills for cars, passed in 1982 and 1983.

Transplant operations with zone status are subject to many of the same criticisms as other types of foreign direct investment in this country, but a 1989 congressional study also cautioned, "[T]he granting of subzones status to the traditional domestic firms may also pose a long-term threat to our nation's economic well-being."[3] While there has been little opposition to general-purpose zones over the years, the boom in manufacturing operations with subzone status has raised questions about the impact of subzones on American jobs, competitiveness and trade relations.

Impact of Subzones

In general, manufacturers confronted with inverted tariffs are responsible for most zone activity. While the opportunity to reduce tariffs on imported components is a key incentive for manufacturers to seek subzone status, this move also is one of the most controversial aspects of the FTZ program.

Inverted Tariffs and Imports - Trade experts note that FTZs give American producers some of the same advantages as offshore manufacturers, better enabling domestic products to compete with imported finished goods. Proponents stress that the program displaces imported final products, since, in their measure, a product manufactured in this country incorporating some foreign components outweighs an import made wholly of foreign materials. Yet some domestic industries counter that the program encourages imports.

Domestic producers of automotive parts, for example, see the inverted tariff situation as particularly damaging to their industry. Although tariffs on imported automotive parts average 4 percent but may be as high as 11 percent, the tariff on assembled cars is 2.5 percent. Not only do automotive assembly plants dominate subzone activity, most automotive assembly operations in the United States are conducted in subzones. The U.S. automotive parts industry contends that subzone operations, by permitting reduced tariffs on imported automotive parts, make American parts producers less able to compete. According to one representative of the parts industry, "[S]ubzones subsidize parts tariffs, transforming what Congress intended as a modest boost to local sourcing and turning that on its head by transforming it into an import incentive."[4]

The $8.3 billion-plus of foreign-sourced automotive parts flowing into subzones in 1989 represented 12 percent of all merchandise received in subzones

[3]Committee on Government Operations, op. cit., p. 12.

[4]Statement of Lee Kadrich, Automotive Parts and Accessories Association, Inc. at hearing on Foreign Trade Zones held by Committee on Government Operations, Subcommittee on Commerce, Consumer and Monetary Affairs, March 7, 1989.

that year and 58 percent of all foreign goods shipped into subzones. In 1986 the share of parts and materials imported into automotive subzones was 15 percent, down from 54 percent in 1979. Moreover, the Foreign Trade Zones Board reported that 18 percent of the $60 billion in parts used by automotive assembly plants in 1989 was of foreign origin. The drop in the percentage of automotive parts imported into subzones is said to stem in part from increased use of subzones by domestic automakers, which use fewer foreign components. The lower figure also reflects greater domestic sourcing of components by Japanese-affiliated U.S. motor vehicle plants, which also buy from Japanese parts suppliers that have set up operations in this country.

U.S. automotive parts makers are not the only critics of the FTZ program. A 1989 General Accounting Office study concluded that, in effect, "[T]he United States has unilaterally reduced tariffs on auto parts, at least insofar as they are destined for use by auto manufacturers, without obtaining compensating tariff reductions from other countries, as may have been done if these tariff reductions had been effected through multilateral trade negotiations."[5] Moreover, the report stated, "[T]he marginal savings obtained through zone procedures neither provide domestic plants with a meaningful competitive advantage against imported cars nor provide significant incentive for locating production in this country." Both of these conclusions, however, have been countered by zone users. Although opponents of the FTZ program have questioned the impact of subzones on tariff revenues, the 1989 GAO report concluded that it would be difficult to ascertain the overall effect.

Employment Levels - Japanese companies assembling cars and trucks in the United States often are accused of relying too much on Japanese parts suppliers, whether located here or at home, and thus contributing to the demise of their American counterparts. Yet the job displacement effect of the transplants' sourcing is unclear. In fact, there is little agreement on the impact of any type of FTZ activity on overall U.S. employment. A 1984 GAO study concluded that at the local level the impact of FTZs on employment levels appeared to range from no change to gains. The study's attempts to gauge long-term employment effects at the national level resulting from the FTZ program were inconclusive.[6] A 1988 study by the International Trade Commission estimated that the FTZ program resulted in net employment losses ranging from zero to about 10,300, with the majority stemming from the automotive industry. The study cautioned, however, that these estimates may not reflect an accurate picture of changes in long-term U.S. employment levels. As an example of the varying effects of the FTZ program among different industries, the ITC report noted that while the automotive parts industry experienced significant job losses as a result of the growth in the program, employment opportunities in the automotive assembly industry itself grew.

The National Association of Foreign Trade Zones estimates that approximately two jobs are created or retained outside a FTZ's boundaries for each job within a zone. Thus, the estimated 137,000 FTZ positions correlate to more than

[5]U.S. General Accounting Office, Foreign Trade Zones Program Needs Clarified Criteria, Report to the Chairman, Committee on Ways and Means, House of Representatives (Washington, D.C.: February 1989).

[6]GAO, 1984, op. cit., p. 27.

400,000 jobs in this country, the association says. Yet some industries stress that unless high value-added components are supplied by American manufacturers, the real benefits of zone manufacturing are exported.

Proposed Regulatory Changes

Many industry executives and analysts believe that changes in the use of FTZs necessitate adjustments in the way the program is run. The regulations implementing the Foreign Trade Zone Act of 1934 have not been revised formally since 1971, and most observers agree that the criteria used for approving FTZ applications need clarification. In particular, critics contend that the "public interest" provision is inadequate. Although the FTZ Board assesses the economic impact of granting a zone license, some critics argue that there is insufficient analysis of the potential effects on relevant domestic industries and on the national economy. These critics add that the lack of clear guidelines for approving proposed FTZs has led to a gap between the regulations and the practices of the board and, therefore, inconsistent consideration of applications.

In 1983 the board proposed regulations aimed at resolving these and other problems in the operation of the FTZ program, but these changes never were adopted. After further examination of the program in congressional hearings as well as in reports and studies by GAO and ITC, the FTZ Board again proposed regulatory changes in January 1990. These incorporated the 1983 suggestions as well as input from various reports and comments. The Department of Commerce noted that among the most significant revisions were "the listing of definitive criteria and procedures for manufacturing activity and subzones."

Last November the board amended its proposed regulations in response to numerous public comments; since then nearly 180 submissions have been received. Many of the comments were critical of the proposal to establish user fees to cover the costs of processing zone applications. A Commerce Department analyst said the board still is looking at ways to address the problems with this section. The new rules also would require zone applicants to provide the board with more information; subzone applicants would be required to submit evidence that significant public benefits would result from their manufacturing operations.

The National Association of Foreign Trade Zones contends that the proposed regulations are too restrictive and are overly burdensome for potential FTZ users. Yet representatives of the domestic automotive parts industry argue that the board's evaluation of a zone's impact on public interest should be even more deliberate, giving, for example, greater weight to such factors as potential harm to competing companies and evaluations of the negative impact on the U.S. trade imbalance. The FTZ Board is considering these and other disputed points of the proposed regulations. The board hopes to publish the final rules in July and put them into effect soon after, according to a Commerce Department analyst.

Congressional Outlook on FTZs

In contrast to active consideration of the FTZ program in several congressional committees a couple of years ago, Capitol Hill has been fairly quiet on this issue recently. There have been no major legislative initiatives

addressing FTZs in the 102nd Congress, in part, congressional observers note, because a broad consensus is absent on Capitol Hill for changing the FTZ regulations one way or the other. No action was taken on a 1990 bill aimed at improving the FTZ program, and its sponsors reportedly have not decided whether to reintroduce the legislation this year. Some developing U.S. trade issues, however, may focus greater attention on FTZs.

U.S.-Japan Auto Parts Deficit - Lawmakers' recent criticism of the FTZ program has focused on the U.S. automotive parts industry. Rep. Marcy Kaptur (D, Ohio), a cosponsor of the 1990 FTZ bill, said the program "exacerbates the [auto parts] deficit by providing an incentive to import parts." She also characterized the program as inconsistent with U.S. trade policy initiatives, such as the 1986-87 MOSS (market-oriented, sector-selective) talks on automotive parts with Japan.

In 1990 the U.S. automotive parts deficit with Japan was calculated as $10.5 billion, making it a major factor in that year's overall bilateral trade imbalance of $41.1 billion. A just-released study by the University of Michigan predicts that the automotive parts deficit will reach $22 billion by 1994.[7] The Commerce Department's under secretary for international trade, Michael Farren, recently told a congressional panel that while this prediction may be surprising in light of the numerous Japanese automotive assembly plants established in this country, the figure assumes an increase in replacement parts. Critics have blamed the FTZ program for boosting the replacement market for imported parts simply because of increased access. The Michigan study also concludes that Japanese-owned automotive operations here will not significantly increase their purchases from traditional American parts suppliers; as a result, parts will account for an ever-greater share of the U.S.-Japan automotive trade deficit by 1994 -- 48 percent compared to 1990's 34 percent figure.

This specter of escalating automotive parts imports from Japan is particularly irritating to lawmakers frustrated over the U.S. parts industry's slight inroads into Japanese markets. Congress is expected to take a close look at the U.S. automotive industry in upcoming months, and it seems likely that the impact of FTZs on the domestic automotive parts industry will be considered in this context.

Maquiladoras - The key trade issue currently diverting most lawmakers is the Bush administration's proposed North American Free Trade Agreement. Among the many concerns over the proposed FTA is that it would increase the incentives for Japanese manufacturers to use Mexico as a base for processing goods for the American market.

Japanese firms currently have a relatively limited presence in maquiladoras, assembly plants located in Mexico that benefit from special U.S. and Mexican customs treatment as well as relaxed Mexican foreign investment regulations. Like FTZs, the maquiladora program has advantages for manufacturers since duties on products assembled in Mexico from American-made parts and shipped back to the United States are levied only on the value added in Mexico

7"Farren Sees 'Increased Attention' For Escalating Auto Parts Deficit With Japan," Inside U.S. Trade, May 3, 1991, pp. 4-5.

and foreign materials. FTZs on the U.S. side of the Mexican border play a role in the maquiladora system by, for example, storing or repackaging components destined for assembly in Mexico.

After the maquiladora program was set up in the 1960s some trade analysts expected Japanese firms to flock to Mexico to bypass U.S. import quotas and other restrictions on Japanese products. But involvement in the maquiladora program by Japanese business had a slow start. The handful of Japanese maquiladoras in the 1970s mostly concentrated on electronics products. Japanese firms' participation in the program accelerated with the expansion of U.S. car and truck assembly plants in the 1980s. Yet by late 1988 Japanese operations represented only about 3 percent of all maquiladoras in Mexico.

The majority of Japanese maquiladoras in operation in late 1988 had capital backing from Japanese affiliates in the United States. Like American companies, these affiliates benefited from transferring certain labor-intensive parts of their production processes to Mexico. Given Mexico's low wage scales and its proximity to the U.S. market, analysts expect the Japanese presence in the maquiladora system to expand. Although the impact of the proposed NAFTA on the maquiladoras is uncertain, some trade experts predict that the program will continue to be utilized by manufacturers that find it more cost-effective to base some part of their operations in Mexico.

The debate surrounding Japanese firms' participation in the maquiladora program echoes the pros and cons of their use of FTZs. Allegations that the program allows Japanese manufacturers to bypass U.S. trade restrictions and more readily increase imports into the American market are countered by arguments that Japanese maquiladora operations lead to jobs in this country that otherwise might have gone to other regions, particularly the Pacific Rim.

Outlook

Both the FTZ and the maquiladora programs were established in part to boost the international competitiveness of U.S. producers. There is little consensus in this country on whether the benefits that these programs also provide to Japanese manufacturers serve the long-term economic interests of the United States. While FTZs have not played a major role in U.S.-Japan trade relations, their connection to the contentious dispute over automotive parts imports puts the program under the microscope in light of the growing U.S.-Japan automotive parts deficit and bilateral trade tensions. Although changes in the operation of the FTZ program may ease some concerns, subzones in particular are unlikely to escape further attention as Congress takes an increasingly critical look at U.S. international competitiveness.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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